

Regional Economic Update

A Quarterly Publication on Banking and Economic Conditions in the Eighth District

- **Overview:** Industrial loan corporations come into the limelight with the recent application by Wal-Mart to start one. The economy appears to be borrowing from the future to grow today. Community banks, meanwhile, end 2005 with a strong performance. House-price appreciation remains modest for most of the Midwest states.
- **Supervisory Implications:** Industrial banks are avenues that allow the mixing of banking with commerce. Historically this mixing has been seen as impermissible. As the structure of loan-portfolios at community banks shifts towards commercial real estate, they need to update their risk management practices.

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- ♦ Wal-Mart's application to start an industrial bank has rekindled several debates and has been met with a lot of rebuke from public groups and community banks.

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- ♦ Though US economic growth is strong, it is tarnished by a high national debt and a low saving rate. This borrowed growth could negatively impact the future.

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- ♦ Commercial real estate continues to fuel loan growth at community banks. Meanwhile, earnings and profitability remain healthy.

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- ♦ Unemployment rates have fallen both nationally and locally. Job growth, however, continues to be a concern for the District.

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- ♦ Commercial real estate recovery continues from the 2001 recession. Though US house-price appreciation remains hot, the District has witnessed moderate increase in house prices.

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- ♦ The fear over the spread of bird flu has resulted in increased testing and screening of migratory birds by the US Department of Agriculture.

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- ♦ Community banks continue to maintain higher net interest margin than bigger banks. However, NIMs at District community banks continue to underperform those at peer banks.

* The opinions expressed are those of the contributors and not necessarily those of the Federal Reserve Bank of St. Louis or the Federal Reserve System. The analyses and data presented are the most recent available at the time of publication and are subject to revision.

Special Feature

By Rajeev R. Bhaskar and William R. Emmons



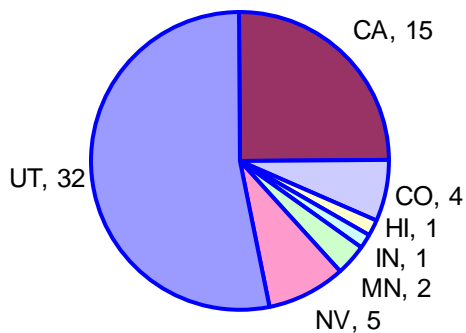
Wal-Mart's ILC Application

FACT: Wal-Mart applied for an Industrial Loan Corporation (ILC) charter from the State of Utah and for deposit insurance from the FDIC in July 2005, but neither application has been decided.

ANALYSIS: Although ILCs have been around for over a century, Wal-Mart's application brings them back into the limelight. It raises the question of Fed oversight and the risks associated with ILCs as their assets grow exponentially.

▪ **What is an ILC?** Industrial loan corporations (also known as industrial banks) started as limited-purpose institutions in the early 1900s, lending to low and moderate income workers. ILCs are state-chartered financial institutions that have remained small niche players for a majority of their existence, meeting the borrowing needs of industrial workers. FDIC insurance was offered to ILCs for the first time in 1982; subsequently many states changed their laws to make obtaining insurance mandatory. The Competitive Equality Banking Act (CEBA), which was passed by Congress in 1987, let the parents of ILCs be exempt from the Bank Holding Company Act (BHCA) federal supervision. This resulted in an increased interest of non-financial institutions—such as General Motors and Toyota—in the ILC charter.

Figure S1. Number of ILCs Charters By State as of December 2005

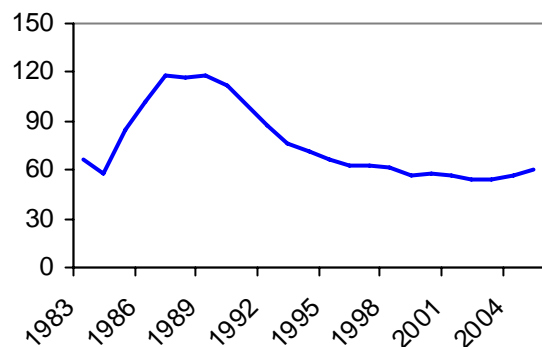


Source: Call Report Data

There are about 60 insured ILCs today, a vast majority of which operate from Utah (32) and California (15) as shown in Figure S1. Figure S2 shows the trend in the number of ILCs over the last

twenty years. Depending on the charter, ILCs may engage in similar activities as other FDIC-insured depository institutions. For example, they may offer a full range of loans, including consumer, commercial and residential real estate, small business, and sub-prime loans. ILCs may also offer NOW (Negotiated Order of Withdrawal) accounts to individuals and nonprofit organizations. However, most ILCs, whose parents are exempt from BHCA, may not offer demand deposits to customers. ILCs are subject to the same federal safety and soundness safeguards and consumer protection laws that apply to other FDIC-insured organizations.

Figure S2. Number of ILCs

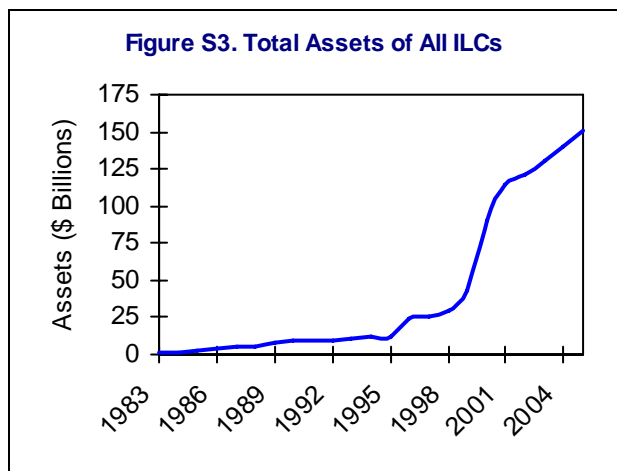


Source: Call Report Data

▪ **The concern over the growth of ILCs.** Since the passing of CEBA in 1987, there has been a tremendous increase in the total assets owned by ILCs. Figure S3 shows the growth in the size of the industry. Total assets owned by ILCs in December 2005 were \$150 billion, compared to \$5 billion in December 1987—an increase of approximately

3000 percent in 18 years (or a compounded annual growth rate of 21 percent).

From a group of small niche players, ILCs now account for some of the larger financial institutions in the country. Merrill Lynch owns the largest ILC, an institution with over \$60 billion of assets. There is concern among the regulatory community that ILCs are expanding beyond their intended purpose, and there is debate on whether any legislative action should be taken to change this.



Source: Call Report Data

Another major concern over the growth of assets of ILCs is the lack of Fed oversight for the parent company. The BHC Act allows the Federal Reserve to supervise the holding companies of banks and assess the risk at the institution due to its association with the parent. However, holding companies of ILCs operate under an exemption from the BHC Act. There is also concern that mixing commerce with banking would stretch the federal safety net, initially intended for banks, to commercial entities. There is a widely held belief that this very prohibition (of mixing commerce with banking) may have been the cause of the stability of the American economy for much of the 20th century.

▪ **Wal-Mart's application.** The BHCA exemption for ILCs that was retained in 1987, has allowed a number of non-financial corporations to start an ILC, including G.E., G.M., Volvo, Toyota, and Target (see Figure S4 for the top 5 ILCs). Wal-Mart's application has drawn much more attention to ILCs than ever before, particularly because of its overall size and its geographic reach into many communities. Wal-Mart touts itself as the largest

company in the world, with revenues topping \$287 billion in 2005. It has over 3,900 stores located across the U.S. and plans to build many more.

Figure S4. Top Five Industrial Banks by Assets as of December 2005

- Merrill Lynch Bank (\$ 60.37 B)
- UBS Bank (\$ 18.59 B)
- American Express Centurion Bank (\$ 15.93 B)
- Freemont Investment & Loan (\$ 11.32 B)
- Morgan Stanley Bank (\$ 8.7 B)

Source: Call Report Data

As a part of its application, Wal-Mart has stated that it would not open retail-banking outlets in its stores. The primary purpose of its ILC will be to process the credit and debit card transactions generated in its own stores. Wal-Mart would use the industrial bank to save on third-party processing fees (merchant-discount fees paid to merchant acquirers) and increase operational efficiencies. Wal-Mart says it would pass the cost savings on to its customers.

Because the business plan filed by Wal-Mart as part of its charter application is much narrower in scope than some of the existing ILC charters, it may be difficult for the FDIC to deny it on the grounds of risks to the safety and soundness of the deposit-insurance fund.

▪ **Implications.** Industrial banks are FDIC insured and can engage in most of the activities of commercial banks and other depository institutions, including accepting certain type of deposits and making loans. Thus, in principle they pose the same risk to the bank insurance fund and to financial stability as other banks. Supervisors were already concerned about the sharp growth in the size of industrial banks, so Wal-Mart's application has heightened their concern.

Wal-Mart's application has drawn much opposition and criticism from the banking industry, unions, and consumer groups. They fear that Wal-Mart would, at some point, expand into retail banking by opening bank branches in many or all of

its stores. Community banks might be no match for the economic might and clout of Wal-Mart. In response, Wal-Mart has offered to put down in writing, as part of its charter application, that it would never open bank branches. Critics are not convinced, contending that Wal-Mart's ultimate aim probably is to dominate small-town banking the same way it dominates small-town retailing.

▪ **Public hearings by the FDIC.** After a huge public outcry regarding Wal-Mart's application, the FDIC agreed to hold public hearings. This is the first time the FDIC has held public hearings for a deposit-insurance application in its 73-year history.

The first two days of hearings were held in Arlington, Virginia, on April 10-11. A third day of hearings took place on April 25, in Overland Park, Kansas. A total of 68 witnesses appeared during the three days of hearings, including Jane Thompson, President of Wal-Mart Financial Services, and about 30 representatives of community banks. Several other trade associations and community-development groups were represented, along with one sitting member of Congress (Stephanie Tubbs Jones, U.S. Representative from Ohio), several former members of Congress, concerned citizens, and an assortment of other interested parties. Three high-ranking FDIC staff members presided over the hearings.

▪ **What is likely to happen?** The FDIC board has indicated that it will not make a decision on Wal-Mart's deposit-insurance application until a permanent FDIC chairman has been installed (Martin J. Gruenberg is the Acting Chairman and has declined to act on the application in the

meantime). As of late April, the Administration has not nominated a successor to Donald E. Powell, who left the FDIC to deal with the aftermath of the Gulf-Coast hurricanes late last year.

Analysts following the issue agree that, given its limited scope, the Wal-Mart application for deposit insurance appears solid on its own merits. The FDIC has granted deposit-insurance coverage to dozens of ILCs already, including one owned by Target Stores, a major Wal-Mart competitor. It would be difficult to argue that the Wal-Mart ILC application is qualitatively different than those already approved by the FDIC for other companies.

The FDIC has the power to deny the application on the basis of the "character" of the parent company, as many participants at the public hearings urged the agency to do. Wal-Mart has offered to put in its application that it has no plans to enter retail banking, and that it would agree to file a new application if it ever decided to do so. There is also a chance that Congress might address the CEBA-created ILC "loophole," but this appears unlikely any time soon.

In the end, it appears most likely that Wal-Mart will receive an ILC charter and federal deposit insurance. It probably will stick to payments processing for the foreseeable future. However, there is no guarantee that Wal-Mart will never seek to enter retail banking. Community bankers and their supervisors should keep a wary eye on Wal-Mart and all other ILC operators, as they constitute another potential competitive threat to community banks.

Supervisory Issues

- ◆ *Are community banks prepared to compete with a Wal-Mart Bank if it were to enter retail banking with in-store branches?*
- ◆ *Would a limited-purpose Wal-Mart ILC, pursuing only a payments-processing business plan, affect banks involved in the payment-card business?*

Economy Watch

By William R. Emmons

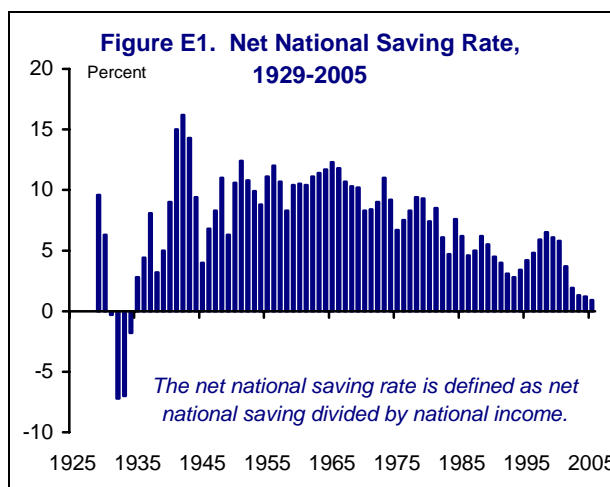
► The U.S. Economy in 2006: Living on Borrowed Time and Money

FACT: The national debt ratio—debt of all non-financial sectors of the economy as a percent of national income—rose to 242 percent by the end of 2005, an all-time high. The net national saving rate fell to 0.9 percent of national income during 2005, its lowest level since 1934.

ANALYSIS: The net national saving rate is the broadest measure of the economic resources we are setting aside today to ensure future prosperity. Today's extremely low saving rate and high debt levels will put downward pressure on future economic growth rates. We are, in effect, borrowing economic growth from the future in order to spend more today.

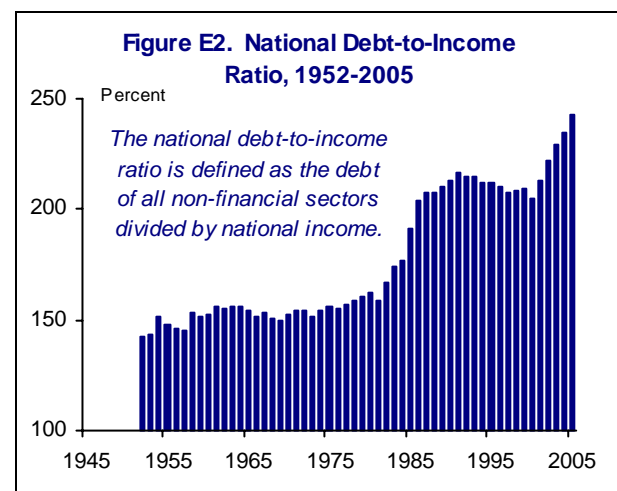
▪ **Lowest saving rates since the Great Depression.** Net national saving is defined as the total saving of the household, business, and government sectors of the economy minus depreciation on the capital assets owned by all three sectors. The net national saving rate is net national saving divided by national income, which, in turn, is composed of the earnings of all workers and owners of capital resident in the United States.

U.S. net national saving rates during 2002-2005 were 1.9, 1.3, 1.2, and 0.9 percent, respectively (Figure E1). This downward trajectory continues a trend of falling saving rates that goes back about four decades, albeit with interruptions such as the investment boom of the late 1990s.



Source: Bureau of Economic Analysis

Using data starting in 1929, the only years before 2002 during which the net national saving rate was under two percent were 1931, 1932, 1933, and 1934—that is, in the depths of the Great Depression. The economy was so depressed for so long during the early 1930s that survival trumped planning for the future for many people. Saving and investment were so low during the Depression that the economy's capital stock actually shrank in economic terms, as depreciation exceeded newly installed plant, equipment, and buildings during four consecutive years.



Sources: Bureau of Economic Analysis and Federal Reserve Board.

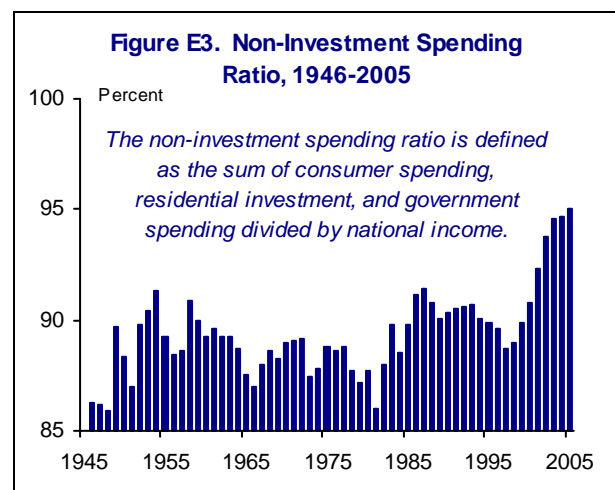
▪ **Why save when you can borrow?** Access to credit today has never been easier or more widespread in the U.S. economy. The total accumulated debt of the household, business

(excluding financial firms), and government sectors exceeded \$26 trillion by the end of 2005, compared to national income of under \$11 trillion last year. The national debt-to-income ratio continued its recent ascent, topping 242 percent in 2005 (Figure E2).

Both Federal Reserve monetary policy and the Federal Government's tax and spending policies contributed to the surge in borrowing during the last five years. Willing lenders from overseas allowed U.S. borrowers to lever up their balance sheets with minimal short-term financial strain.

▪ **Spending like there's no tomorrow.** Why are net national saving rates so low now? Is basic survival at stake for large segments of the population, so that investing in the future has become an unaffordable luxury?

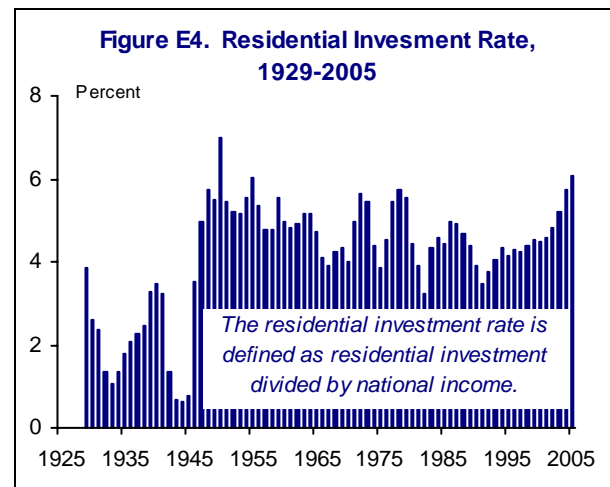
Hardly! The U.S. is, in fact, enjoying a "consumer boom"—that is, an unusually large fraction of national income is being spent on consumer goods and services, new housing, and government programs of various types (Figure E3). These forms of spending enhance current living standards, but do nothing to ensure continued high future levels of prosperity.



Source: Bureau of Economic Analysis.

Perhaps the clearest evidence that today's ultra-low saving rates are the result of very different forces than those at work during the Great Depression or other "hard times," such as World War II, is the extraordinarily high current rate of spending on new residential investment (Figure E4). When economic resources are tight, as during the Depression or World War II, it is rational to

postpone expenditures on new or upgraded housing so long as basic accommodations are available. When households feel very wealthy, on the other hand, it is rational to "splurge" on upgrading existing housing units or building new ones. This seems to be what is occurring now.



Source: Bureau of Economic Analysis

▪ **Everyone complains about the low saving rate, but nobody does anything about it.** If most economists agree that the low U.S. saving rate is a serious problem, why isn't more being done about it?

The crux of the issue is that the national saving rate is the result of hundreds of millions of people's individual decisions. People respond to incentives, such as the level of interest rates. The Federal Reserve slashed short-term interest rates beginning in 2001, and began to raise them again slowly only in 2004. In effect, the Fed reduced the reward to saving and, at the same time, made borrowing more attractive. Meanwhile, the Federal Government has contributed more than \$2.6 trillion of new debt to the national total since early 2001.

The Fed is well aware of the long-term dangers of a low saving rate. The Federal Reserve Board's February 2006 *Monetary Policy Report* to Congress warned of the looming retirement of the baby-boom generation:

If not reversed over the longer haul, persistent low levels of saving will necessitate either slower capital formation or continued heavy borrowing from abroad, either of which would hamper the ability of the nation to cope with the retirement needs of the baby-boom

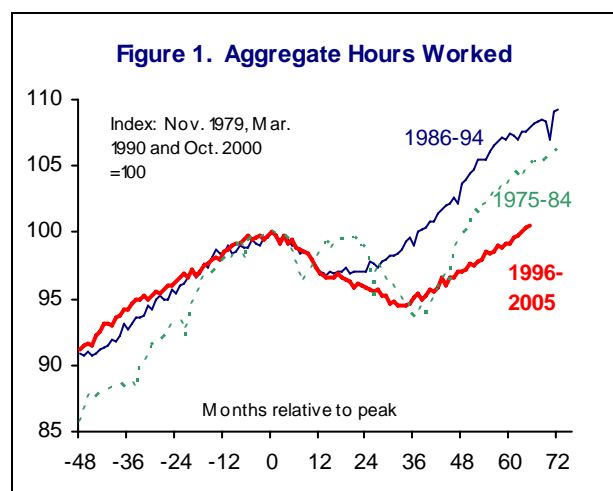
generation and would retard the growth of the standard of living.

The Federal Reserve is raising short-term interest rates, which should restore some of the appeal of saving. Congress and the Administration say they would like to reduce the federal budget deficit, which would add directly to national saving.

And, perhaps most important of all, international investors may tire of pouring hundreds of billions of dollars each year into the U.S., a country that seems unable or unwilling to contribute many of its own ample resources to the attainment of its own future economic prosperity. A sharp deterioration of our terms of trade (i.e., a weakening of the dollar) may be the ultimate “kick in the seat of the pants” that turns a nation of spenders into one of savers—for its own good.

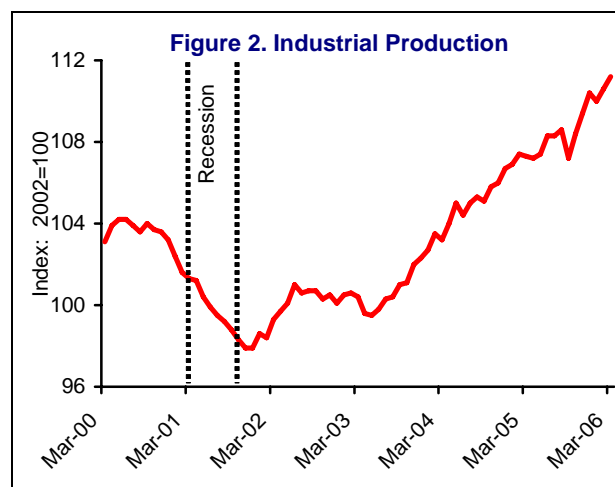
A review of key economic indicators

▪ **Economic growth continues.** The labor market has created more than five million net new jobs since bottoming out in mid-2003. Even so, this economic expansion remains one of the weakest on record, as measured by the index of aggregate hours worked (Figure 1). This measure of the private sector’s demand for labor only recently surpassed the peak it attained during October 2000. Wage growth also has remained weak throughout this recovery.



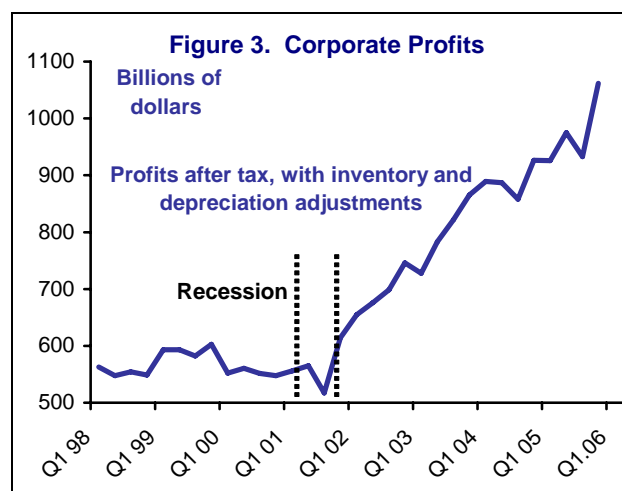
Source: Bureau of Labor Statistics

▪ **Industrial production recovers after hurricanes.** The index of industrial production fell sharply in September 2005, but has rebounded subsequently (Figure 2). Capacity utilization in manufacturing has increased significantly since 2003, but remains below levels reached during previous economic expansions. This widely followed measure of economic slack probably is not signaling any imminent inflationary pressures in the economy. It would take another year or more of production growth at this pace to raise the alarm of looming capacity shortages.



Source: Federal Reserve

▪ **Corporate profits surge anew.** The spectacular recovery of corporate profits from the 2001 recession continued through year-end 2005 (Figure 3). After-tax corporate profits have more than doubled in just over four years. Non-financial corporations’ profits have nearly tripled since the fourth quarter of 2001.



Source: Department of Commerce

▪ **FOMC meeting minutes signal the end of the tightening campaign may be approaching.**

New Federal Reserve Board Chairman Ben Bernanke and the Federal Open Market Committee raised the federal-funds rate target by 25 basis points, to 4.75 percent, at their March 2006 meeting. This marked the 15th consecutive time they increased the target rate by one-quarter percentage point.

The minutes of the March 27-28 meeting (released April 18) contained statements that financial-markets participants interpreted as signals that the end of rate increases may be approaching sooner than expected. In particular, some committee members worried aloud at the meeting that investors could misinterpret the FOMC's intentions and push market rates higher than would

be consistent with committee members' judgments on the strength of inflationary pressures.

Before Chairman Bernanke assumed his position early this year, the expected "stopping rate" for the fed-funds target was about 4.75 percent, which is its current level. As economic strength continued during March and early April 2006, market expectations of the ultimate peak in the funds target drifted upward to 5.25 percent. This rate was expected to be in place by about October 2006.

The FOMC meeting minutes released April 18 immediately reduced the odds placed by the market consensus (inferred from the prices of fed-funds futures contracts) on an ultimate peak of 5.25 percent. Only further data releases and the passage of time will reveal the committee's intentions.

Supervisory Issues

- ♦ *Are banks prepared for slower growth of borrowing by debt-burdened households?*
- ♦ *Are banks exposed to a larger increase in interest rate than currently anticipated?*

Community Bank Performance

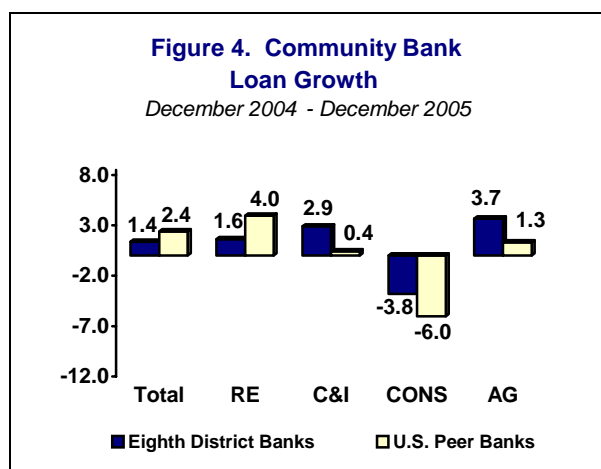
By Rajeev R. Bhaskar

Community Banks Continue to Perform Well

FACT: Loan growth at community banks slows down a bit, but continues to be positive. Earnings remain steady despite a flat yield curve.

ANALYSIS: The structure of the loan portfolio at community banks continues to shift towards commercial real estate, whereas, the consumer-loan portion continues to shrink.

▪ **Loan growth slows.**¹ Loans outstanding at Eighth District community banks increased 1.4 percent (\$874 million) between December 2004 and December 2005, as illustrated in Figure 4. Loan growth at peer banks registered slightly higher at 2.4 percent. The year-over-year loan growth for District banks in September 2005, in comparison, was 2.0 percent.



District loan growth over the past twelve months was positive primarily because of strong commercial real estate lending. Construction and land-development loans increased 22.4 percent (\$1.2 billion), and non-farm, non-residential loans rose 0.6 percent (\$83 million). Meanwhile, 1- to 4-family mortgages fell 2.5 percent (\$472 million), and home-equity lines of credit fell 7.0 percent (\$132 million). Amongst the other loan categories,

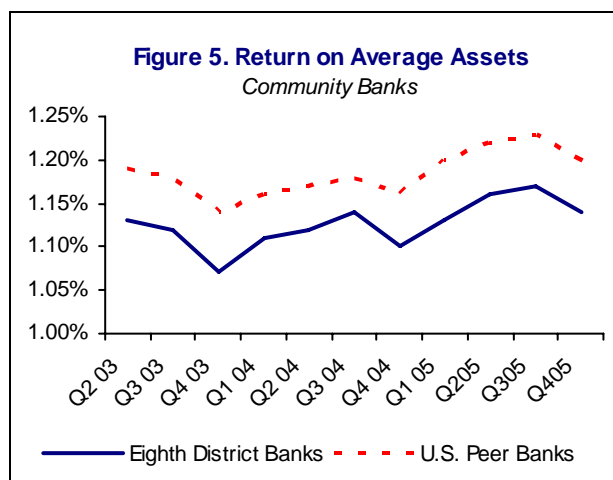
commercial and industrial loans grew by 2.9 percent over the year, while consumer loans fell by 3.8 percent.

▪ **Earnings remain steady.** Between December 2004 and December 2005, net interest margins (NIMs) in the District increased 3 basis points to 4.07 percent. Peer NIMs have also grown slowly but remain substantially above those at District community banks, averaging 4.33 percent. Interest income was 6.13 percent of average assets for the quarter ending December 2005, up 44 basis points from December 2004. Similarly, interest expense was 2.07 percent, up 42 basis points from a year ago.

Figure 5 shows the year-to-date (Y-T-D) return on average assets (ROA) at community banks on an annualized basis for the last ten quarters. After two years of relatively flat growth, earnings have picked up somewhat in 2005. The ROA at District banks for the fourth quarter of 2005 was 1.14 percent, up 4 basis points from the fourth quarter of 2004. District ROA is now 6 basis points below the peer level.²

¹ Data in the "Community Bank Performance" section are from the FFIEC Consolidated Reports of Condition and Income. "Community banks" refers to banks with assets less than \$500 million, of which there were 707 in the District in the most recent quarter. "Peer banks" refers to all U.S. community banks.

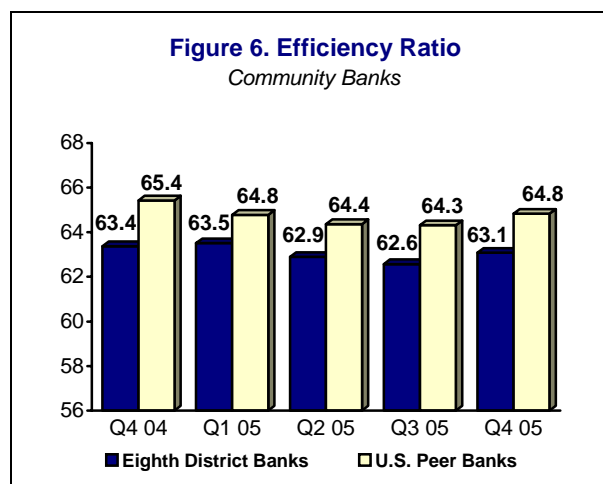
² ROA at the District's 160 Subchapter S community banks averaged 1.69 percent in the fourth quarter, compared to 0.99 percent for all other District community banks.



ROA at District banks was higher partly due to lower provision expense. The provision for loan losses in the fourth quarter of 2005 was 0.20 percent of assets, compared to 0.22 percent for the fourth quarter of 2004. Net noninterest expense, on the other hand, was unchanged from a year ago at 1.99 percent of average assets. Still, this number was 18 basis points lower than the peer bank net noninterest expense of 2.17 percent.

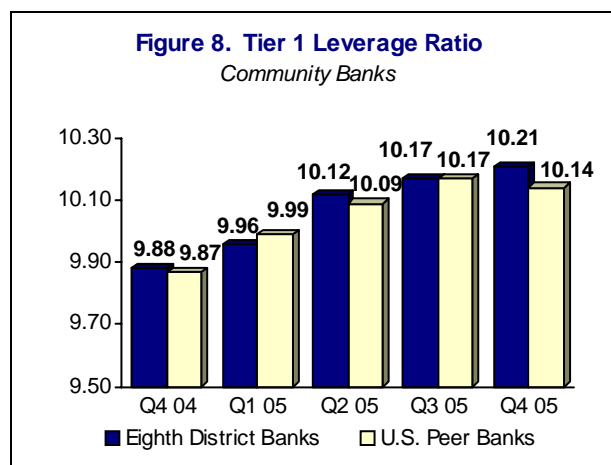
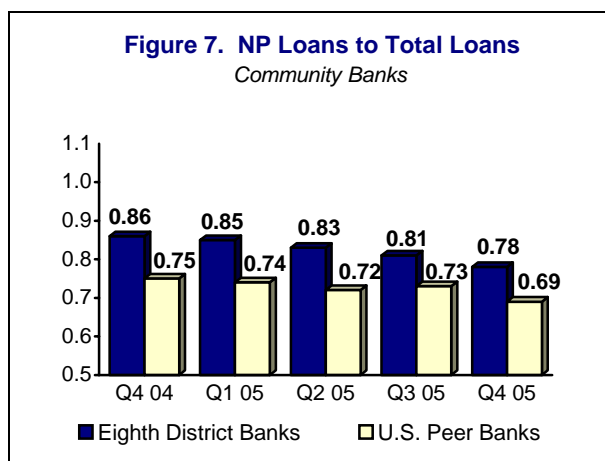
The efficiency ratio was 63.1 percent in December 2005, 30 basis points lower than its value in December 2004 (Figure 6). District efficiency ratios continue to compare favorably to those in the rest of the country.

▪ **Liquidity risk looms.** Growth in deposits at District banks continues to stagnate—total deposits were down 1.0 percent from December 2004. Meanwhile, loan growth remains positive. Total assets at District community banks fell by 0.7 percent, driving up the total loan-to-asset ratio 1.3 percentage points to 66.6 percent. These trends, together with the continued tightening of monetary policy, may make liquidity management a challenge for some community banks in the near future.



Federal funds purchased and repurchase agreements by District community banks rose 9.3 percent between December 2004 and December 2005, while federal funds sold were down 2.2 percent, suggesting difficulties in meeting short-term liquidity needs. In addition, a drop in securities holdings of 6.3 percent and an increase in noncore funding of 6.9 percent helped to make up the difference between loan growth and core funding. This dependence on non-deposit funding suggests liquidity could become a concern for banks as long as loan demand and interest rates continue to rise together.

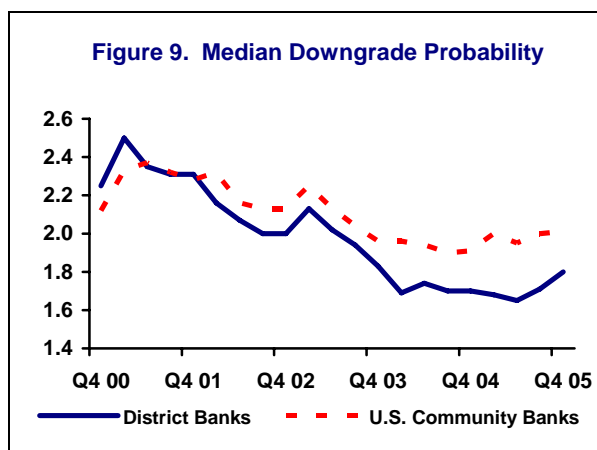
▪ **Asset quality continues to improve.** As Figure 7 illustrates, asset quality at District banks and across the country improved in the fourth quarter of 2005. The ratio of nonperforming loans to total loans at District community banks fell 8 basis points over the year to 0.78 percent. This ratio is still higher than the peer average of 0.69 percent. The net decrease was a result of improvements across all categories of the loan portfolio. In addition, total loan losses were down 3 basis points over the year to 0.23 percent of total loans.



▪ **Capital levels rise.** Over the past year, capital levels at District community banks increased. As Figure 8 shows, the Tier 1 leverage ratio rose 33 basis points from December 2004 to 10.21 percent in December 2005. Meanwhile, the peer average also rose 27 basis points to 10.14 percent.

Coverage ratios (loan-loss reserves divided by nonperforming loans) also continued to climb, boosted by a small decrease in loan-loss reserves compared to a larger decrease in nonperformings. Loan-loss reserves fell only slightly, primarily because charge-offs were down. Among District community banks, the average coverage ratio rose 10.1 percentage points over the year, to 174.1 percent. Nevertheless, District coverage ratios continue to lag the peer banks' ratios by about 11.7 percentage points.

▪ **Average downgrade probabilities remain low.** The District median CAMELS downgrade probability increased from 1.70 percent to 1.80 percent between December 2004 and December 2005 (Figure 9).⁴ The median downgrade probability for U.S. peer banks is 2.01 percent. Currently, 3.8 percent of District banks are rated CAMELS 3, 4, or 5, slightly lower than the 4.3 percent ratio in the previous quarter and well below the 5.1 percent ratio in December 2004. It is also lower than the 5.0 percent ratio for U.S. community banks.



Supervisory Issues

- ◆ *As the loan concentration at community banks shifts towards commercial real estate, are the banks' risk management practices and skills keeping pace with this shift?*

⁴ CAMELS-downgrade probabilities are computed quarterly by SPA, based on the most recent call report data. For more information see: [Could a CAMELS Downgrade Model Improve Off-site Surveillance?](#) by Alton Gilbert, Andrew Meyer and Mark Vaughan, *St. Louis Fed Review*, 2002.

Eighth District Labor Markets

By Rajeev R. Bhaskar and William R. Emmons

► **National Labor Markets Pick Up Pace, While Growth Remains Slow For the District**

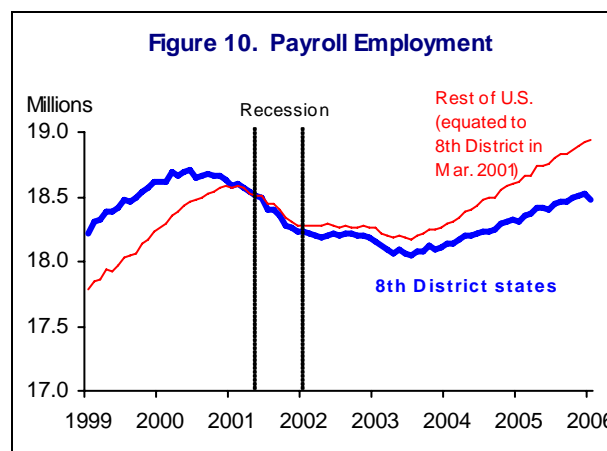
FACT: Unemployment rates in the seven states of the District fell over the past year but remain above the U.S. average.

ANALYSIS: Employment continues to be a concern for the District states, despite a strong economy.

▪ **Employment growth remains slow in District.** The seven states that make up the Eighth District gained 171,100 jobs during the twelve months through January 2006, an increase of about 0.9 percent. (Figure 10). Employment in the rest of the nation increased almost twice as fast at about 1.7 percent during the same time period. These growth rates are still lower in comparison to the 2-percent-plus growth rates enjoyed both in the Eighth District and nationwide for seven consecutive years in the 1990s. Thus, the job-market recovery remains unusually weak—particularly in the Eighth District.

▪ **Manufacturing contraction continues in the District.** All seven states in the Eighth District had manufacturing employment shares near or above the national average going into the 2001 recession. Compared to the U.S. average of 12.8 percent in March 2001, District state manufacturing employment shares ranged from Missouri's 11.6 percent to Indiana's 19.4 percent.

Manufacturing nationwide lost about 3.2 million jobs during the seven years ending in February 2006, or 18 percent of the 1999 level. The decline of labor in manufacturing continues to be a concern for the year 2006, especially because most of the District states depend heavily on manufacturing as a source of employment. The nation lost about 48,000 manufacturing jobs during the twelve months through February 2006; the Eighth District states in comparison lost 26,600 manufacturing jobs. In short, the manufacturing industry is unlikely to generate significant loan demand at Midwest banks.



Source: Bureau of Labor Statistics

Table 1. State and Regional Unemployment Rates⁴

State	January 2005 (%)	January 2006 (%)
Arkansas	5.1	4.3
Illinois	5.9	5.2
Indiana	5.6	4.7
Kentucky	5.4	6.3
Mississippi	6.9	8.4
Missouri	5.9	4.7
Tennessee	5.5	5.1
Seven-State Region	5.8	5.5
Entire U.S.	5.2	4.7

⁴ State and national labor data are seasonally adjusted. Metropolitan Statistical Area (MSA)-level data are not seasonally adjusted and, therefore, are not directly comparable to the state data.

▪ **Unemployment rates fall.** The U.S. unemployment rate fell 50 basis points over the last year to 4.7 percent in January 2006. This rate is amongst the lowest rates in the last four years. Unemployment in the region's states also saw a decline with only two states—Kentucky and Mississippi—registering an increase from last year's level (Table 1). The average unemployment rate for the District states decreased 30 basis points over the twelve months ending January 2006 to 5.5 percent. Missouri with an unemployment rate 4.7 percent, registered the largest drop among District states of 1.2 percentage points. Arkansas, meanwhile, was the only state with an unemployment rate below the national average.

Table 2. Unemployment Rates of Selected MSAs

MSA	January 2005 (%)	January 2006 (%)
Chicago	5.9	5.6
Evansville	5.4	5.0
Indianapolis	5.3	4.7
Kansas City	6.5	5.3
Little Rock	5.4	4.3
Louisville	5.6	6.5
Memphis	7.3	6.1
Nashville	5.0	4.4
St. Louis	6.7	5.5

▪ **MSA unemployment rates are lower.** Unemployment rates of the major metropolitan statistical areas (MSAs) in the region were lower than last year's levels (Table 2). Many of the MSAs saw a decrease in the unemployment rate of 100 basis points or more in the period between January 2005 and January 2006. Louisville was the only metro area in the region that registered higher unemployment than last year. However, most of the region's MSAs still had a higher unemployment rate than the national average of 4.7 percent. Because MSAs are the centers for economic activity, lower unemployment trends could be a signal of growth pick-up in the region as a whole.

Supervisory Issues

- ♦ *The District continues to suffer from higher unemployment and lower job growth compared to the rest of the nation. Will this disadvantage the community banks in our region?*

Real Estate

By Rajeev R. Bhaskar

Real Estate Markets Continue to Grow

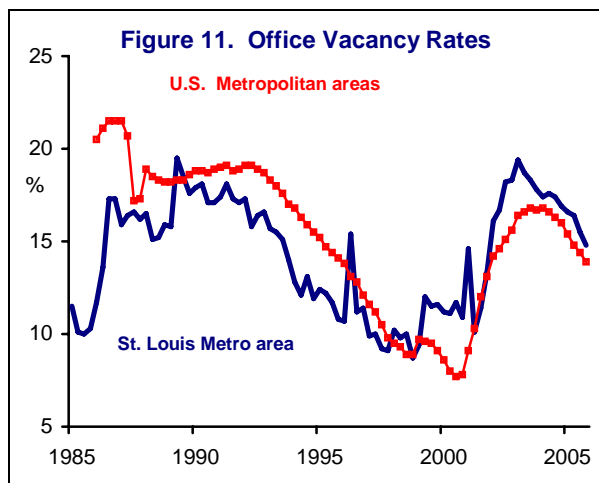
FACT: Commercial real-estate markets are recovering, while residential markets remain hot.

ANALYSIS: Though house-price appreciation is high nationally, it remains modest for much of the District.

Commercial Real Estate Markets

▪ **Office markets' recovery continues.**

Office market vacancy rates continue to decline. Figure 11 shows that the average office vacancy rate in U.S. metropolitan areas edged down to 13.9 percent during the fourth quarter of 2005. This rate compares to a rate of 16.0 percent a year ago, when the office market was still weak. This marks the seventh straight quarter of positive absorption for the downtown and suburban markets. The decline in office vacancy rates is a sign that companies expect to expand their service-sector work force.

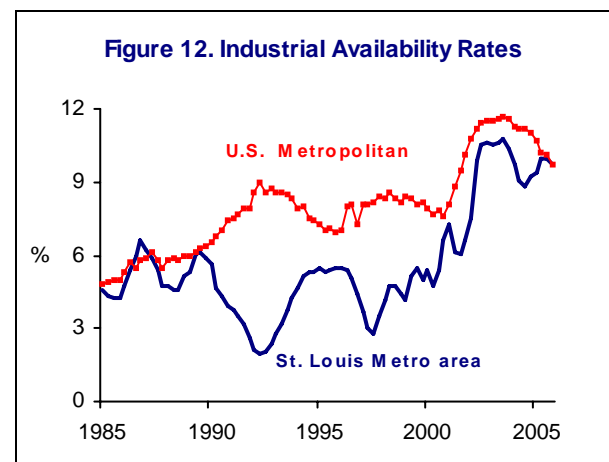


Source: CB Richard Ellis

The average office vacancy rate in the St. Louis metropolitan area moved down to 14.8 percent during the fourth quarter of 2005, compared to its worst level of 19.4 percent in early 2003. The St. Louis vacancy rate was lower than both Chicago's 16.9 percent rate and Kansas City's 17.8 percent rate.

▪ **Industrial markets improve.** Industrial real estate—production and warehouse facilities—improved in the fourth quarter of 2005. Figure 12

shows an average industrial real estate availability rate in U.S. metropolitan areas of 9.7 percent during the fourth quarter of 2005, down from its year-ago level of 11.0 percent. Industrial availability rates follow trends in production and trade, which have improved. Further take-up of industrial space is likely in the quarters ahead.



Source: CB Richard Ellis

Similar to the national trends, the industrial availability rate in the St. Louis metro area fell to 9.7 percent during the fourth quarter of 2005 from 10.0 percent the previous year. The availability rate remains significantly above the 6.0 percent reached during late 2001⁵. Chicago's industrial availability rate of 9.7 percent was the same as the U.S. average, while Kansas City had a slightly higher industrial availability rate of 10.3 percent. The improvement in the industrial real-estate market may be a signal for even higher CRE loan-growth opportunities for banks.

⁵ The St. Louis metro area availability rate is computed as a four-quarter moving average to smooth the volatility.

Residential Real Estate Markets

▪ House-price appreciation remains high.

U.S. average existing home prices surged 13.0 percent between the fourth quarters of 2004 and 2005. Adjusted for inflation, the average house price rose 9.0 percent. This increase is among the fastest house price increases recorded in at least 30 years (the time span of reliable data). It appears increasingly likely that house prices in many regions have become disconnected from fundamentals such as household income and may correct downward at some point in the future.

Average house prices in Eighth District states increased much less than the national average over the last four quarters, but still faster than inflation (Table 3). Most of the substantial appreciation still appears to be in the coastal states, with the middle part of the country showing lesser appreciation. Among District states, Illinois and Tennessee experienced the strongest increases in house prices in the region, whereas Indiana and Kentucky experienced the least increase.

Table 3. Average Price Increases of Existing Houses by State

<i>State</i>	<i>House-Price Index Q4' 05 (4-quarter % change)</i>	<i>Real Increases Q4' 05 (Deflated by CPI less shelter; 4-quarter % change)</i>
Arkansas	7.5	3.5
Illinois	9.4	5.4
Indiana	4.7	0.7
Kentucky	5.3	1.3
Mississippi	7.4	3.4
Missouri	7.1	3.1
Tennessee	8.1	4.1
U.S.	13.0	9.0

Sources: Office of Federal Housing Enterprise Oversight; Bureau of Labor Statistics

▪ District metropolitan areas post mild real house-price appreciation.

Most of the metro areas in the District posted mild real house-price appreciation (Table 4). Of the metro areas in the region, Chicago experienced the highest rise in house prices of 10.7 percent for the year ending December 2005. Nevertheless, it ranked just 119 among all U.S. metro areas. Evansville and Louisville experienced the weakest rise in house prices, with Evansville posting negative real house price appreciation of -1.4 percent.

Table 4. Average Price Increases of Existing Houses by Metropolitan Statistical Area

<i>MSA</i>	<i>House-Price Index Q4' 05 (4-quarter % change)</i>	<i>Real Increases Q4' 05 (Deflated by CPI less shelter; 4-quarter % change)</i>
Chicago	10.7	6.7
Evansville	2.6	-1.4
Indianapolis	4.9	0.9
Kansas City	4.9	0.9
Little Rock	6.8	2.8
Louisville	4.5	0.5
Memphis	4.6	0.6
Nashville	8.5	4.5
St. Louis	8.0	4.0
U.S.	13.0	9.0

Sources: Office of Federal Housing Enterprise Oversight; Bureau of Labor Statistics

▪ **Mortgage rates edge upwards.** Since July 2004 the FOMC has pushed its federal-funds target rate up by 375 basis points to 4.75 percent. This has had little impact on the 30-year fixed mortgage rate for most of this time. However, since the fourth quarter of 2005 mortgages have begun to edge upwards and currently stand at 6.5 percent as of March 2006. Nevertheless, this rate is well below the peak of 8.6 percent reached five years ago. Banks should expect to experience growth in their residential real estate loans as long as mortgage rates remain historically low.

Supervisory Issues

- ♦ *If the froth in the housing market trickles down to the Midwest states, do banks have adequate credit rating tools and policies in place to avoid losses?*

Agricultural Conditions

By Rajeev R. Bhaskar

Fear Over the Spread of Bird Flu Results in Increased Testing and Decreased Consumption

FACT: The bird flu has spread rapidly through Asia, Europe, and Africa. There is fear that it could spread to North America through migratory birds.

ANALYSIS: The fear of the spread of bird flu has pushed the US government to take increased testing and screening measures. It has also suppressed global consumption of poultry.

▪ **Concern over bird flu.** The Avian Influenza (or the bird flu) is a disease caused by a virus that affects poultry and wild birds such as geese, ducks, and shorebirds. The H5N1 strain of this virus is deadly to domestic fowl and can be transmitted to humans. It has spread rapidly across Asia, much of Europe, and parts of Africa. Currently this strain of the bird flu is not present in North America, but there is fear that it could spread to this part of the globe through migratory birds.

The US government is taking necessary steps to monitor the spread of the bird flu and to minimize its potential impact. The US Department of Agriculture (USDA) along with other agencies is working with Alaskan biologists to sample live birds for the pathogenic H5N1 strain. Thousands of birds have been tested; so far all have tested negative for the virus. Nevertheless, the fear of bird flu has depressed poultry sales in the US and Europe. Poultry exports were down 30 percent in December 2005 from a year ago due to a decrease in global consumption. Chicken prices are also expected to be substantially lower for the first quarter of 2006.

▪ **Less corn acreage expected in 2006.** The USDA projects that 2006 could see a 5 percent decline in corn fields, which would be the biggest drop in US corn acreage in over 20 years. The primary reason is that farmers are preferring to plant soybeans over corn. The shift towards soybeans is due to lower input costs as well as a higher global demand compared to corn. Soybean acreage is expected to go up by 7 percent for this year. However, if the demand for ethanol as an

alternate fuel source continues, it would pick up the demand for corn as well.

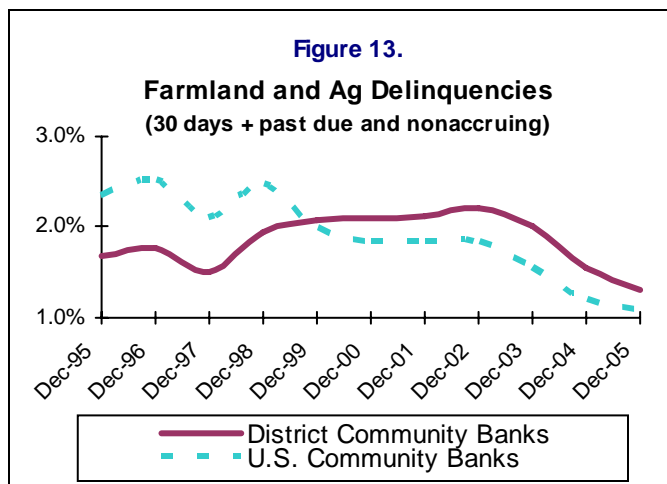
▪ **Crop prices are higher.** Prices for most of the major crops were slightly higher compared to last year (Table 5). Cotton was \$0.50 per pound in March 2006, compared to \$0.40 per pound in March 2005. Rice prices were also sharply higher at \$8.05 per Cwt compared to \$6.97 per Cwt a year ago. Corn prices, however, were relatively unchanged at \$2.01 per bushel in March 2006. Livestock prices on the other hand were slightly lower on average over the same period. The higher crop prices will likely offset lower livestock prices, and, as a result on average there may be little change in revenues for farmers. Consequently, agricultural performance is expected to be stable.

Table 5. Key Agricultural Prices

<i>Product</i>	<i>Mar 2006</i>	<i>Feb 2006</i>	<i>Mar 2005</i>
Broilers (Lb)	0.37	0.38	0.44
Cattle (Cwt)	89.2	92.4	91.0
Corn (Bu)	2.01	2.02	2.02
Cotton (Lb)	0.50	0.49	0.40
Eggs (Doz)	0.66	0.50	0.53
Hogs (Cwt)	42.4	42.6	51.2
Rice (Cwt)	8.05	7.97	6.97
Soybeans (Bu)	5.55	5.67	5.95
Wheat (Bu)	3.71	3.66	3.42

Source: National Agricultural Statistics Service

▪ **Ag asset quality improves as delinquencies fall.** The agricultural loan quality at District community banks continues to improve. Nonperforming agricultural and farmland-secured loans fell 21 basis points between December 2004 and December 2005 to 0.73 percent of total agricultural loans. Figure 13 shows fourth-quarter delinquencies of farmland and agricultural loans over the past ten years. For both the Eighth District and the U.S., there has been a downward trend in this ratio since the end of 2002.



Source: FFIEC Consolidated Reports of Condition and Income

Supervisory Issues

- ◆ *Have bankers assessed how a bird flu pandemic could affect their agricultural loans? Are agricultural provisions adequate?*

Capital Markets

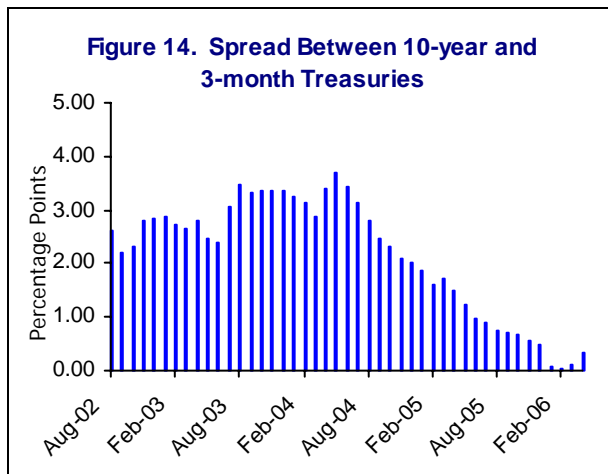
By Gary S. Corner

District Banks Continue to Maintain a Steady Net Interest Margin

FACT: The net interest margins of District banks have held relatively steady despite the flat yield curve environment.

ANALYSIS: Overall, the strength of their core deposit base has allowed community banks to mitigate funding cost pressures, at least in the short-term. In fact, some community banks have experienced a slight margin expansion driven by their asset repricing characteristics.

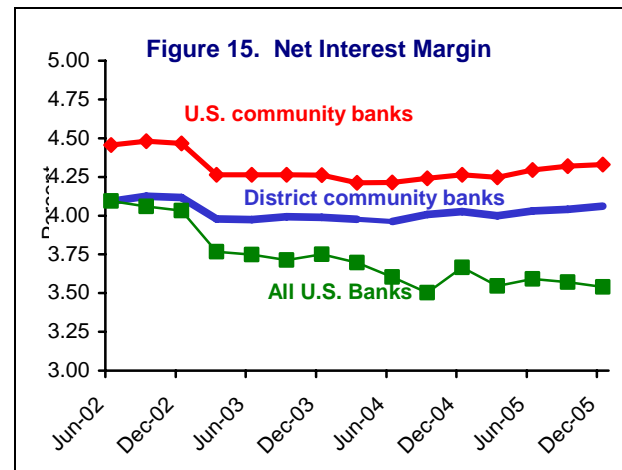
▪ **The yield curve remains flat.** The yield curve remains very flat by historical standards and is an ongoing source of pressure on bank earnings. Figure 14 plots the average monthly spread between the 10-year and 3-month Treasuries and highlights the spread weakness. Despite the aggressive Fed tightening, long-term rates have remained stubbornly low. During March, this stubbornness somewhat eased as the spread widened by 32 basis points. Indeed, spread widening continued into April as the yield on the 10-year Treasury note reached a two-year peak of more than 5 percent.



Source: Federal Reserve

▪ **Net interest margin has held relatively steady at District Community Banks.** Over the course of 2005, the aggregate net interest margin (NIM) at District community banks has fared somewhat better than the average of all banks nationally (a measure dominated by large banks). In contrast, District community bank margins on

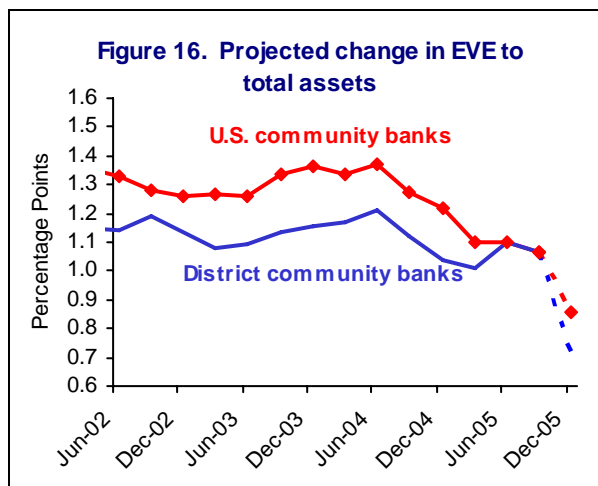
average continue to lag margins at peer banks. Why the disparity in District community bank performance with the rest of the nation? Perhaps it points to the positive interest rate risk-buffering effect of core deposits when comparing District community banks to the large-bank dominated national measure. Or in contrast, it may highlight more modest lending opportunities within the District when comparing with national community banks. Nonetheless, the performance differentials shown in Figure 15 cannot be fully explained by any single factor.



Source: Call Reports

▪ **Rising rate exposure remains modest.** Most District banks remain disciplined in response to yield curve uncertainty. Figure 16 plots the absolute value of the projected change in economic value of equity (EVE) to total assets given a 200 basis-point parallel shift in the yield curve. Higher equity changes reflect higher rate sensitivity. As

illustrated in the figure, on average District SMBs are projected to lose 0.71 percent of their equity given the rate shock. This measure indicates somewhat less interest rate risk than the national community bank average of 0.85 percent. Both District and national community bank risk measures have declined significantly from the prior quarter. This significant decline in apparent risk taking might be misleading. Rather than an absolute decline in inherent interest rate risk, the change is caused by a significant change in our risk measurement calculation. In December 2005, updated risk weights were applied to each balance sheet category of our simple economic value model. The adjustment of risk weights better calibrates our risk measure to current market conditions but significantly diminishes the near-term comparative analysis. Comparison of interest rate risk within the district to the national average remains valid.



Source: Federal Reserve Focus Reports

Supervisory Issues

- ◆ *Community banks rely significantly on the interest rate protection provided by their stable core funding base. Their ability to retain funds and hold down cost could diminish the further the rate cycle progresses. Interest rate and liquidity pressures may develop as market conditions may provide a meaningful incentive for depositors to shift or reprice funds.*
- ◆ *District bankers should remain disciplined in asset selection in order to balance margin pressure and exposure to rising interest rates.*

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